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Supreme Court of the United States

OCTOBER TERM, 1985

LUBRIZOL ENTERPRISES, INC.,
Petitioner,

v.

ROBERT A. CANFIELD, BANKRUPTCY TRUSTEE FOR RICHMOND METAL FINISHERS, INC.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF AMICUS CURIAE FOR COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION (CBEMA) IN SUPPORT OF THE PETITIONER

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TABLE OF CONTENTS

	Page
INTEREST OF THE AMICUS CURIAE	2
STATEMENT OF THE CASE	4
SUMMARY OF ARGUMENT	4
ARGUMENT	5
I. This Court Should Grant The Writ To Prevent The Fourth Circuit's Decision From Adversely Affecting The Entire Structure Of The Information Processing Industry, Its Manner Of Doing Business, Its Users And The Public At Large	5
II. This Court Should Grant The Writ To Prevent The Arbitrary And Inequitable Deprivation Of The Licensee's Rights	7
A. This Court Should Grant The Writ To Protect A Licensee's Reasonable Expectation That Completed Performance Under A Contract Cannot Be Undone	7
B. This Court Should Grant The Writ To Protect Against The Arbitrary Characterization Of All Licensing Agreements As Executory Contracts	8
C. This Court Should Grant The Writ To Ensure That Equitable Considerations Are Not Eliminated From A Vital Part of the Bankruptcy Process	10
CONCLUSION	12

TABLE OF AUTHORITIES

Cases: Page

In re Gladding Corp., 22 Bankr. 632 (Bankr. D. Mass. 1982) 9

In re Petur U.S.A. Instrument Co., 35 Bankr. 561 (Bankr. W.D. Wash. 1983) 9, 11, 12

N.L.R.B. v. Bildisco & Bildisco, 104 S.Ct. 1188 (1984) 9

Codes:

11 U.S.C. § 365 (1982) ..... *passim*

Law Reviews:

Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439 (1973) 10

Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 Minn. L. Rev. 479 (1974) 9

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BRIEF AMICUS CURIAE FOR COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION (CBEMA) IN SUPPORT OF THE PETITIONER

Computer and Business Equipment Manufacturers Association ("CBEMA") submits this brief as amicus curiae in support of Lubrizol Enterprises, Inc.'s ("Lubrizol") Petition for A Writ of Certiorari to the United States Court of Appeals For the Fourth Circuit filed on November 19, 1985. Pursuant to Rule 36.1 of the Rules of the Supreme Court of the United States, this brief is

submitted with the written consent of the parties filed simultaneously with the Clerk.

INTEREST OF THE AMICUS CURIAE

CBEMA, formerly known as the Business Equipment Manufacturers Association, is the trade association which has represented the computer and business equipment industry since 1916. The companies comprising the current CBEMA membership include the nation's leading manufacturers of computers, telecommunications and business equipment and related supplies and services. CBEMA is the leading spokesman for the computer and business equipment industry, representing some 34 companies,[1] both large and small, having an estimated combined sales of over $135 billion. Member companies of the association include both hardware and software manufacturers and provide over 1.2 million job opportunities throughout the United States. While product lines of member companies vary widely, the following list is illustrative: electronic computers, computer software including programs, computer input and output devices, computer storage devices, support services, telecommunications equipment, optical character readers, addressing machines, accounting machines, bookkeeping machines, office

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[1] The following companies are members of CBEMA; 3M; Amdahl Corporation; AMP Incorporated; Apple Computer, Inc.; AT&T; Bell & Howell; Burroughs Corporation; Control Data Corporation; Dictaphone Corporation; Digital Equipment Corporation; Eastman Kodak Company; GF Furniture Systems, Inc.; Harris/Lanier; Hewlett-Packard Company; Honeywell Information Systems, Inc.; IBM Corporation; ICL, Incorporated; Information Handling Services; Micro Switch, a Honeywell Division; AM International, Inc.; NCR Corporation; Panasonic Industrial Company; Philips Business Systems, Inc.; Prime Computer, Inc.; Royal Business Machines, Inc.; Sanders Associates, Inc.; SMA Corporation; Sony Corporation of America; Tektronix, Inc.; Terminal Data Corporation; Texas Instruments Incorporated; UARCO Incorporated; Visual Technology Corporation; and Xerox Corporation.

copying machines, and supplies and services for these products.

CBEMA companies have consistently been forerunners in developing information processing technology. In addition, they have contributed greatly to the present significant status and role of information processing in modern society and the international competitiveness of the United States in this industry. The extent to which such products and services can be utilized effectively depends in great measure on the ability of CBEMA companies to engage in licensing transactions, either as licensor or licensee, for the use of new technology and know-how.

These member companies are continuously involved in licensing transactions, either as licensor or licensee, for the transfer of intellectual property related to the hardware and software products which they manufacture, use or market. Licensing is particularly crucial in the software segment of the industry since in today's marketplace, software is usually copyrighted so that transactions are accomplished most frequently by licenses rather than by sales. Whether the user is an individual or an organization, the transfer of computer software is accomplished not by direct sale but pursuant to a license to use.

Licensing transactions may take many forms. They may be transactions which provide needed financing to small innovative enterprises. They may involve multi-tiered licenses of technology with a number of entities. Whatever the form, licensing is one of the principal methods of technology transfer throughout the world. Licensing, therefore, must remain a predictable and safe business transaction.

The subject matter of the present case is one of great significance for the CBEMA membership. These companies are vitally concerned with the protection of licensing agreements, since licensing is a central business practice of the industry. The Fourth Circuit's decision adversely

impacts upon both the immediate and the future planning of CBEMA companies with respect to the ways and means of transferring intellectual property. The transfer of intellectual property is necessary for promoting the use of information processing products, for research and development and for many other aspects of the information processing industry. The Fourth Circuit's decision inevitably affects the future growth and development of the information processing industry in the United States, and has even a greater impact on the vast segments of our society which use and receive the benefits of this technology.

STATEMENT OF THE CASE

The facts and proceedings below are fully set forth in the Petition For A Writ Of Certiorari To The United States Court of Appeals For The Fourth Circuit filed by Petitioner Lubrizol Enterprises, Inc., on November 19, 1985.

SUMMARY OF ARGUMENT

The question of whether § 365 of the Bankruptcy Code, 11 U.S.C. § 365,[2] authorizes the bankruptcy court, on request of the debtor, to rescind all contractual obligations divesting the nondebtor of property it had already acquired under the contract prior to the bankruptcy filing is one which the Supreme Court should resolve now.

The language of § 365 and equitable principles normally relied upon in bankruptcy point powerfully in one direction. The holding below points in the other. Everyday contractual relationships are now in jeopardy because, under the Fourth Circuit's erroneous interpretation of § 365, each party fears that the other party will file for bankruptcy and seek complete recission of the performance rendered prior to the bankruptcy.

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[2] The statute at issue here, Bankruptcy Reform Act of 1978, § 365, 11 U.S.C. § 365 (1982), is reprinted in the Appendix to the Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit filed November 19, 1985 at 43a-49a ("Petition for Certiorari"). The statute will be referred to as § 365.

The Fourth Circuit has erred (1) by deciding that contracts are "executory" based solely on continuing, but insignificant and unburdensome, obligations between the parties and (2) by subjecting the nondebtor, who in this case is the licensee, to arbitrary and unfair results without taking into account equitable considerations.

This Court should eliminate the error caused by the Fourth Circuit's decision and restore the predictability so needed to maintain viable contractual relationships in today's business climate.

ARGUMENT

REASONS FOR GRANTING THE WRIT

I. This Court Should Grant The Writ To Prevent The Fourth Circuit's Decision From Adversely Affecting The Entire Structure Of The Information Processing Industry, Its Manner Of Doing Business, Its Users And The Public At Large

This case is not merely an isolated dispute between two parties. It has broad-scale implications for the entire information processing industry. If the Fourth Circuit's decision is permitted to stand unreviewed, licensing contracts are now a risky, unpredictable and undesireable means of transferring new technology and know-how in the computer industry. Licensing has been an indispensable part of everyday business for CBEMA's membership, for the information processing industry and for information processing users as a whole. The latter comprise virtually the entire business base of the industrial world.

As it stands now, the Fourth Circuit has held that, if a court finds a contract to be "executory," the licensor [3]

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[3] This brief deals with a dispute involving a technology licensor's bankruptcy proceeding. All references, therefore, to licensor refer to the debtor, and all references to licensee refer to the non-debtor.

having filed for bankruptcy has unfettered and unquestioned ability to cancel all obligations under the contract, and even to recoup transfers of property made prior to the filing of the petition for bankruptcy. This decision leaves the licensee helpless to protect its rights to property transferred prior to the licensor's bankruptcy petition.[4]

Without review by this Court, many adverse ramifications affecting this industry will flow from the Fourth Circuit's decision. Among the most apparent are:

- Investment in and plans for the development of innovative technology will be stunted and may never come to fruition. Without a licensee's marketing and development, new ideas may never surface in the marketplace or be exploited for the benefit of the industry or the public.
- The benefits of much technological innovation will be lost and an industry, whose existence depends on fast-developing technology, will be injured.
- Companies may seek to circumvent the "executory" nature of a licensing contract and enter only those contracts that cannot be found by the courts to be "executory." For example, a licensee may be forced to make all royalty payments at the commencement of the contract. For many companies, such payments would be too costly and will inhibit their desire to license the technology.
- The cost of doing business will increase in order for licensees to cover the enormous risks of licensing technology in good faith and later losing all rights to such technology pursuant to § 365.

The Fourth Circuit's decision, as it stands, will influence far more than a dispute between Lubrizol and the

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[4] The Fourth Circuit decision, reported at 756 F.2d 1043 (4th Cir. 1985), is reprinted in the Appendix to the Petition for Certiorari at 1a-10a.

bankrupt; it will exert an adverse impact on the everyday business transactions of the entire information processing industry.

II. This Court Should Grant The Writ To Prevent The Arbitrary And Inequitable Deprivation Of The Licensee's Rights

A. *This Court Should Grant The Writ To Protect A Licensee's Reasonable Expectation That Completed Performance Under A Contract Cannot Be Undone*

The Fourth Circuit's decision, as it stands, will cause drastic consequences for the licensee relying on its agreement with the licensor to make use of certain software technology. For example, a licensee may have obtained the use of a licensor's software for the purpose of developing and maintaining a much needed bookkeeping system for its business. The licensing agreement may provide that the licensor must update the bookkeeping software on a periodic basis while the licensee must make ongoing payments. The licensor may file for bankruptcy many years later. Based on the Fourth Circuit's erroneous interpretation of § 365, the licensor will succeed in its bid to convince the bankruptcy court that the licensing agreement constitutes an executory contract. Under the Fourth Circuit's decision, the licensor is relieved of all past and future obligations under the licensing agreement. The licensee, therefore, will lose its right to use the bookkeeping software on which its business now depends. This result, by itself, could force a licensee into dire straits.

Another situation exemplifies the gross inequities resulting from the Fourth Circuit's decision. A licensor may own a patent on a unique manufacturing process which it agrees that the licensee may use. The licensing agreement may provide that the licensor is obligated to sue any companies infringing on the patent and that the licensee is obligated to make ongoing payments. In order to accommodate the unique process, the licensee may be forced to make massive capital expenditures. The licensor

subsequently may file for bankruptcy and, pursuant to § 365, convince the bankruptcy court to reject all its obligations under the licensing agreement because the licensor's promise to sue the infringers made the agreement "executory" in nature. Under the Fourth Circuit's decision, the licensee would lose not only its right to make use of the manufacturing process but also the capital expenditures that the licensee made in reliance on the agreement. The ripple effects of such a loss on the licensee's business could force the licensee into bankruptcy or, at best, into severe economic hardship.

This Court should grant the writ in order to review two premises underlying the Fourth Circuit's decision which lead to such inequitable results: first, whether any or all licenses are properly viewed as *per se* executory; and second, whether courts may continue to rely on equitable considerations to prevent an arbitrary and inequitable deprivation of the licensee's rights when considering whether to assume or reject contractual obligations under § 365.

B. *This Court Should Grant The Writ To Protect Against The Arbitrary Characterization Of All Licensing Agreements As Executory Contracts*

Most future obligations in technology licensing agreements are insignificant compared to the accomplished transfer of intellectual property, and in fact are *de minimis* in nature. They place no real affirmative burdens on the parties and should not trigger the drastic results that, based on the Fourth Circuit's decision, flow from the designation of "executory" contract.

The Fourth Circuit's decision depriving the licensee of the property it acquired from the debtor prior to the latter's filing for bankruptcy turned entirely upon a characterization of the contract as "executory" under § 365. Even where any future obligations under the agreement are merely insignificant and contingent, the debtor under the Fourth Circuit's decision is given an automatic right to rescind all contractual obligations performed before it filed for bankruptcy.

Congress did not expressly define the term "executory contract" as used in the Bankruptcy Code. No statutory definition, therefore, can be mechanically applied for the purpose of rejecting the contract. *See In re Petur U.S.A. Instrument Co.*, 35 Bankr. 561, 563 (Bankr. W.D. Wash. 1983) ("The Code does not define the term 'executory contract' "). Rather, the analysis of whether a contract is executory is judicially-fashioned and should not result in arbitrary and inequitable decisions.[5] As the court recognized in *In re Gladding Corp.*, 22 Bankr. 632, 635 Bankr. D. Mass. 1982):

> It seems clear, at least to this court, that bankruptcy courts should not be bound by static definitions of what is an executory contract, but should strive to satisfy the purposes of the Act in conjunction with the goals of the debtor (or trustee), in order that equity may be served.

Because the term "executory contract" is not defined in the statute, courts, including the Fourth Circuit in this case, have looked to Professor Countryman's article on the matter. A careful reading of the entire Countryman article, however, reveals that Professor Countryman did not view licenses as *per se* executory contracts. Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 Minn. L. Rev. 479, 502 (1974) ("Where there is no express undertaking by the licensor [to supply goods or services], the agreement with the licensee may not be executory because the licensor may have full performed merely by executing the license agreement").

The Fourth Circuit's decision, in contrast, assumes that all licenses are fundamentally executory. If the Fourth Circuit's decision is not reviewed by this Court, debtors will acquire a *new* right to rescind all past contractual

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[5] This Court in an entirely different context recognized that whether or not a contract is executory depends on the facts of each individual case. *N.L.R.B. v. Bildisco & Bildisco*, 104 S.Ct. 1188 (1984).

obligations merely because the contract is deemed to be executory.

The conclusion that a contract is executory is based upon the premise that a negative covenant—a promise *not* to take an action—is just as executory as an affirmative covenant. This conclusion, however, is at odds with the history of the treatment of contracts in bankruptcy. The concept underlying § 365 grows out of the well-placed desire to relieve a bankruptcy trustee or debtor-in-possession of ongoing burdensome obligations. *See* Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 440-47 (1973). To equate negative covenants —which generate no burden for the obligor—with affirmative covenants in applying § 365 rejection rights, however, results in an unjust enrichment of the bankruptcy estate for which there is no evidence of congressional intent.

Once the Fourth Circuit mechanically decided that the licensing agreement was "executory," Lubrizol as the licensee was guaranted to lose. This Court should grant review of this matter to examine the Fourth Circuit's assumption that all licensing agreements are necessarily executory contracts and to prevent the destabilizing consequences for business transactions that flow from that characterization.

C. *This Court Should Grant The Writ To Ensure That Equitable Considerations Are Not Eliminated From A Vital Part Of The Bankruptcy Process*

Relying on a static definition of executory contract, the Fourth Circuit applied an arbitrary and mechanized approach to licensing contracts under § 365.[6] Having de-

[6] The requirement of § 365(a) that the trustee's assumption or rejection of an executory contract be "subject to the court's approval" dictates a non-mechanical approach to issues involved in executory contracts. The court must be active in determining what is, and is not, an executory contract and in disposing fairly of those arrangements found to be executory in nature.

cided that the contract was executory, the Fourth Circuit deferred totally to the licensor's decision that it would be advantageous to terminate all rights granted under the agreement. Based on the business judgment rule, the court created an insurmountable burden for the licensee by defining the issue as "whether the decision of the debtor [licensor] that rejection will be advantageous is so manifestly unreasonable that it could not be based on scund business judgment, but only on bad faith, or whim or caprice." [7] The court underscored the difficulty faced by the licensee seeking to protect its interests by stating that this determination is "reviewable up the line under the clearly erroneous standard." [8]

The Fourth Circuit's decision has made it virtually impossible for a licensee to protect its rights in property, in this case technological know-how, transferred by the licensor prior to its bankruptcy. As if to underscore the licensor's complete discretion to eradicate all pre-petition obligations under the licensing agreement, the court held that "equitable considerations" had no place in the court's decision.[9] Rather, the Fourth Circuit stated that licensees "share the general hazards created by § 365 for all business entities dealing with potential bankrupts. . . ." [10]

In direct contrast with this approach is *In re Petur U.S.A. Instrument Co.*, 35 Bankr. 561 (Bankr. W.D. Wash. 1983), where the court balanced the equities of both parties in denying the debtor's motion to reject an executory contract. Despite its agreement with the debtor that the contract was executory and that rejection of the contract would be in its best interests, the court engaged in an independent evaluation of the effect of rejection on

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[7] Petition for Certiorari, Appendix at 7a.

[8] *Id.*

[9] *Id.* at 9a.

[10] *Id.* at 10a.

both parties. In doing so, the court refused merely to rubber-stamp the business judgment of the debtor. The court's major concern was that if it upheld the rejection of the contract, the non-debtor would be forced out of business. 35 Bankr. at 563. The court stated:

> Counsel for the debtor has cited a number of cases involving rejection in which harm has resulted to the non-debtor parties. . . . But here we are not only dealing with harm resulting from a mere disappointment of legitimate expectations. Rather we are dealing with the actual ruination of an otherwise profitable, successful and ongoing business. Equity will not permit such a result.

35 Bankr. at 564 (citations omitted). Looking to equity for assistance, the court properly weighed the business judgment of the debtor against the adverse effects of rejecting the contract on the non-debtor. As the court stated in *In re Petur U.S.A. Instrument Co.*, "[i]t is well-established that bankruptcy proceedings are equitable in their nature." 35 Bankr. at 563.

The Fourth Circuit refused to consider the inequitable effects of its decision on the licensee. This Court should grant review in this case to ensure that equitable considerations remain a viable part of the decision as to whether to assume or reject contractual obligations under § 365.

CONCLUSION

CBEMA respectfully requests that the petition of Lubrizol Enterprises, Inc. be granted (1) to prevent the arbitrary and inequitable deprivation of a licensee's rights to property transferred prior to the debtor's filing for bankruptcy, and (2) to correct an erroneous interpretation of § 365 that will disrupt substantially the predictability of commercial transactions, especially in the information processing industry. The Fourth Circuit's decision should be reviewed and reversed to prevent major un-

certainty and serious inequity from arising out of good faith business transactions.

Respectfully submitted,

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